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Supreme Court, U.S.
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No. 00-

IN THE

Supreme Court of the United States

BITE, INC., a Virginia corporation,

Petitioner,

v.

FIRST NATIONAL BANK, a California corporation,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE CALIFORNIA COURT OF APPEALS, FOURTH APPELLATE DISTRICT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

This Court has given priority to payment out of the proceeds of a federal government contract to the subcontractors, laborers and materialmen on that contract, and to any subrogee of their rights such as a bonding company under a Miller Act bond, if any, ahead of the general contractor or prime contractor, or an assignee or secured party bank of the prime contractor, since *Prairie State Bank v. U.S.*, 164 U.S. 227 (1896) and the relevant cases thereafter cited by this Court in *Dept. of Army v. Blue Fox, Inc.*, 525 U.S. 255, 264-265 (1999). This Court and every other court that has considered the issue has followed this Court in affirming that priority. The California Court of Appeal in this case did not.

The question presented is whether the California Court of Appeal committed error in giving priority to the bank which was the assignee and secured party of the general contractor or prime contractor to payment out of the proceeds of the federal government contract over the claim of petitioner, a subcontractor, laborer and materialman on that federal government project.

STATEMENT PURSUANT TO RULE 29.6

Petitioner has no parent or publicly held company which owns 10% or more of petitioner's stock.

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The judgment of the Court of Appeal of California, Fourth Appellate District, was entered on September 22, 2000. (Appendix A) The Court of Appeal denied a timely petition for rehearing on October 18, 2000. (Appendix C) On December 13, 2000, the Supreme Court of California denied a petition for review.

STATEMENT OF JURISDICTION

The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

STATEMENT OF THE CASE

Petitioner BITE, INC. provided labor and materials to the U.S. Air Force pursuant to a subcontract which it had with SYSTEMS EXPLORATION, INC. ("SEI") which was a subcontract of a prime contract (the "Prime Contract") which SEI had with the U.S. Air Force. BITE has completed its work on that contract and is still owed at least $114,793.22.

Respondent FIRST NATIONAL BANK is a secured creditor of SEI having an assignment of and perfected security interest in the proceeds of all of its contracts including the Prime Contract.

BITE discovered that the BANK was holding approximately $255,000 in proceeds from the Prime Contract in an account identified as, among others, the "Set Aside Account" and the "Subcontractor Account." BITE made demand on the BANK for payment of its claim out of the Subcontractor Account or Set Aside Account.

At the same time, David Miller, the Administrative Contracting Officer for the Defense Contract Management Command charged with administering the Prime Contract, also made demand on the BANK for the unpaid subcontractors, laborers and materialmen on the Prime Contract to be paid ahead of the BANK out of the proceeds of the Prime Contract.

The BANK rejected those demands, and took the proceeds of the Prime Contract and paid them to itself. BITE sued to recover enough of the proceeds of the Prime Contract to pay its claim as an unpaid subcontractor, laborer and materialman on the Prime Contract. We advised the trial court of petitioner's priority under federal law. The trial court granted summary judgment in favor of the BANK. The California Court of Appeal affirmed that summary judgment and the California Supreme Court denied review.

REASONS FOR GRANTING THE WRIT

I. THIS COURT HAS RECOGNIZED THE EQUITABLE PRIORITY OF SUBCONTRACTORS, LABORERS AND MATERIALMEN FIRST TO BE PAID OUT OF THE PROCEEDS OF THE GOVERNMENT CONTRACT FOR OVER 100 YEARS. WHILE THE FEDERAL GOVERNMENT IS NOT LIABLE TO THEM, IT DOES HAVE THE EQUITABLE DUTY TO SEE THAT THEY ARE FIRST PAID OUT OF THOSE PROCEEDS.

This Court from *Prairie State Bank v. United States*, 164 U.S. 227 (1896) through *Department of the Army v. Blue Fox, Inc.*, 525 U.S. 255 (1999) has recognized the equitable priority which subcontractors, laborers and materialmen who work on a federal government project have to be paid first out of the proceeds of that government contract.

This right has uniformly been recognized, whether in the hands of the subcontractors, laborers and materialmen or a surety which has paid their claims under a Miller Act bond, for instance, and is thus subrogated to their rights to priority in payment from the proceeds of the government contract ahead of the prime contractor and his creditors, most commonly his lender bank with an assignment of or perfected security interest in the prime contractor's right to the proceeds of the government contract.

The Court of Appeal in this case reached a contrary conclusion, holding that the BANK, the prime contractor's lender bank and its assignee and secured party, took priority in the proceeds of the government contract over BITE, INC., a subcontractor, laborer and materialman who provided services and materials under the government contract.

Those cases find a corresponding duty on the part of the federal government to protect this priority of the subcontractors, laborers and materialmen on a government project. The BANK in this case frustrated the efforts of the government contracting officer to perform his duty and protect this equitable priority, and instead took the proceeds which had been produced by the work of the subcontractors, laborers and materialmen to repay the prime contractor's debts to the BANK.

Let us first note that there was no Miller Act bond on this project. We thus focus on this alternate case law which has more commonly been used by sureties on government projects after they have paid the unpaid subcontractors, laborers and materialmen whose rights they then assert as subrogees.

Let us review the line of cases discussing this equitable priority of the subcontractors, laborers and materialmen on a government project first to payment out of the proceeds of the government contract.

These cases also establish the lesser principal that, while sovereign immunity keeps the federal government from being liable to the subcontractors, laborers and materialmen, the federal government has the equitable duty to see that they are first paid out of these proceeds.

A. *Prairie State National Bank of Chicago v. U.S.*, 164 U.S. 227 (1896)

This involved Charles Sundberg & Co., a general contractor under a contract "to erect a custom house at Galveston, Tex.," 164 U.S. at 228. Sundberg assigned the final payment to be made to it by the government to a Van Zandt on behalf of Prairie Bank, but Sundberg defaulted and Hitchcock, its surety, completed the prime contract. Both the bank and Hitchcock sought the remaining $11,850 due under the prime contract. This Court noted that Hitchcock had completed the contract and paid Sundberg's bills to complete the contract, which the United States would otherwise have had to do, and held that Hitchcock was entitled to the fund holding that:

> Sundberg & Company could not transfer to the bank any greater rights in the fund than they themselves possessed. Their rights were subordinate to those of the United States and the sureties.

164 U.S. at 240.

B. *Henningsen v. United States Fidelity and Guaranty Co.*, 208 U.S. 404 (1908)

Henningsen was the general contractor "for the construction of certain buildings at Fort Lawton." 208 U.S. at 404 He assigned the payments due to him from the government under the prime contract "to R.R. Spencer, in trust for National Bank of Commerce of Seattle to secure payment of the loan made by the bank to [him]. . . ." 208 U.S. at 405.

U.S.F. & G. filed suit to obtain the remaining $13,066 from the government. This Court noted that Henningsen:

> did not make this payment [to his laborers and materialmen], and the Guaranty Company, as surety, was compelled to and did make the payment. Is its equity superior to that of one who simply loaned money to the contractor . . .? We think it is. It paid the laborers and materialmen, and thus released the contractor from his obligations to them, and to the same extent released the Government from all equitable obligations to see that the laborers and supply men were paid.

208 U.S. at 410.

C. *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132 (1962)

Here the government turned the final $87,737.35 due under the prime contract over to Pearlman, the bankruptcy trustee for Dutcher Construction Corp., the defaulting general contractor. Reliance Ins. Co., the surety which "had been

compelled to pay about $350,000 to discharge debts of the contractor for labor and materials" since "[Dutcher had not] carried out its obligation to pay its laborers and materialmen," 371 U.S. at 134, sued to have the $87,737.35 turned over to it.

This Court, after holding that neither the Miller Act nor its opinion in *United States v. Munsey Trust Co.*, 332 U.S. 234 (1947) had overruled this equitable priority, held:

> that the Government had a right to use the retained fund to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of the fund; that the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the fund and that the surety, having paid the laborers and materialmen, is entitled to the benefit of all of these rights . . .

371 U.S. at 141.

D. *National Surety Corp. v. U.S.*, 133 F. Supp. 381 (Ct. Cl. 1955)

The court first notes:

> These cases involve contests between surety companies on a defaulting contractor's payment bonds and a bank which sues under an assignment of the monies due on the contracts given by the contractor to secure loans by the bank.

133 F. Supp. at 382.

The court goes on to note from *Munsey Trust* the statement of this Court that:

> "we have recognized the peculiarly equitable claim of those responsible for the physical completion of building contracts to be paid from available monies ahead of others whose claims come from the advance of money."

and states:

> We reiterate our former opinion that the equity of the surety company is superior to the rights of the bank acquired under an assignment . . .
>
> [T]he United States is under no legal liability to pay laborers and materialmen; but it is under an equitable obligation to do so . . .
>
> Under such bond the surety guarantees payment of laborers and materialmen, and upon performances of this obligation, it relieves the Unites States from its equitable obligation to see that the laborers and materialmen are paid. For this reason it is subrogated to the right of the United States to apply this money to the payment of laborers and materialmen, in the discharge of its equitable obligation, although the United States was under no legal liability to do so. Since the right of the United States to so use the money is superior to the bank's rights as the contractor's assignee, the right of surety who pays them is superior to the bank's right.

> There would seem to be no doubt of the right of the United States to use the contractor's money in its hands to discharge the contractor's obligation to laborers and materialmen. One of the obligations assumed by the contractor under his contract with the United States was to pay laborers and materialmen. If he fails to do so, the United States has the right to use money due to him to do what he agreed to do. It would be inequitable for the United States to retain the benefits of what the laborers and materialmen had done for it and pay to someone else money which the contractor should have paid to them. See Henningsen v. United States Fidelity & Guaranty Co., supra.
>
> Since the United States is under an equitable obligation to see that laborers and materialmen are paid as held in the Henningsen case, supra, the laborers and materialmen have the equitable right to assert a claim to monies in the hands of the [U.S.] which are due to the contractor. When the surety pays the laborers and materialmen, it becomes subrogated to their right to assert an equitable claim to the monies in the hands of the [U.S.]. It has frequently been held that they have equitable priority to these moneys over the general creditors of the contractor and over his assignees [citations].

133 F. Supp. at 383-384.

This opinion was followed and quoted extensively in *In Re Dutcher Construction Corp.*, 378 F.2d 866 (2d Cir. 1967) including:

> "Since the United States is under an equitable obligation to see that laborers and materialmen are paid, as held in the *Henningsen* case . . . the laborers and materialmen have the equitable right to assert a claim to moneys in the hands of the [government] which are due to the contractor."

378 F.2d at 869.

E. *United States Fidelity & Guaranty Company v. Ernest Construction Company*, 854 F. Supp. 1545 (M.D. Fla. 1994)

This case takes the next step. The surety company got the funds from the government but Ernest Construction, the subcontractor and materialman, let the one year statute of limitations expire on its Miller Act claim, so it asserted this equitable right to proceeds of the government contract in the hands of the surety. The court first noted that:

> the court of claims has repeatedly . . . acknowledged such a right by a *subcontractor* . . .
>
> The approach adopted by this Court today establishes a materialmen's priority to funds claimed either by the government or a performing surety. In summary, the Court recognizes that although a surety's legal obligation to pay pursuant to the bond may lapse upon the expiration of the statute of limitations, as USF&G

> contends here, the *equitable* obligation continues even though USF&G has no *legal* duty to do so . . . *Munsey* – as applied by the court of claims in *National Surety* – does permit a materialman to assert an equitable lien against the holder of monies or benefit, including the government.

854 F. Supp 1560-1561.

The court went on to uphold the equitable priority of the subcontractor and materialman to the proceeds of the prime contract and to grant summary judgment for Ernest Construction on its constructive trust cause of action, reserving for trial the conversion and resulting trust cause of action alleged by Ernest Construction. Our complaint was patterned on this case.

F. *Department of the Army v. Blue Fox, Inc.*, 525 U.S. 255 (1999) and *Blue Fox, Inc. v. Small Business Administration*, 121 F.3d 1357 (9th Cir. 1997)

These cases note the continuing of vitality of this equitable priority of the subcontractors, laborers and materialmen to the proceeds of the government contractor ahead of the secured creditor of the general contractor/ assignee of the proceeds of the prime contract.

This Court, after noting the *Prairie State Bank*, *Henningsen*, *Pearlman* and *Munsey Trust* cases, held that these cases do not override sovereign immunity and,

> Instead, these cases dealt with disputes between private parties [here the BANK and BITE] over

> priority to funds which had been transferred out of the Treasury and as to which the Government had disclaimed any ownership.

525 U.S. at 265. That is precisely our case.

These cases hold that the surety is equitably subrogated to the rights of the subcontractors, laborers and materialmen and thus has priority over the prime contractor's bank, and that the subcontractors, laborers and materialmen as the holders of those equitable rights have priority over the prime contractor's bank.

And we again note the lesser theme, that the federal government, while it is not liable to pay the subcontractors, laborers and materialmen, has the equitable duty to see that they are first paid out of the proceeds of the government contract.

II. THE PRIME CONTRACTOR HAS NO RIGHTS IN THESE PROCEEDS WHICH ARE EARMARKED FOR THE SUBCONTRACTORS, LABORERS AND MATERIALMEN UNLESS AND UNTIL HE PAYS THEM. THUS HE CANNOT CREATE ANY RIGHTS TO THOSE FUNDS IN HIS ASSIGNEE BANK BECAUSE HE HAS NO SUCH RIGHTS. AND § 9203(1)(c) OF THE COMMERCIAL CODE PROVIDES THAT HE CANNOT CREATE A SECURITY INTEREST IN THOSE PROCEEDS UNTIL HE HAS RIGHTS IN THOSE PROCEEDS.

The California Court of Appeal ruled against this 100-years of precedent on the theory that the BANK's security interest was created before the Prime Contract. That ignores

the fact that the prime contractor has no rights in the proceeds of the Prime Contract earmarked for the subcontractors, laborers and materialmen until he pays them.

Thus, because an assignor can only assign what he has, and specifically because § 9203(1)(a) of the Commercial Code provides that a debtor cannot create a security interest until he has rights in the collateral, the California Court of Appeal should have followed this 100 years of precedent and protected the rights of the subcontractors, laborers and materialmen first to be paid out of the proceeds of the federal government contract on which they work.

We invite the Court's attention to *United States v. TAC Construction Co. Inc.*, 760 F. Supp. 590, 593-596 (S.D. Miss. 1991) which is a post-UCC case involving a bank which had an assignment from the prime contractor (as the BANK had here) and also a bank which held a security interest in all of the prime contractor's contract rights (as the BANK here also claims).

A. The Contractor – TAC

> TAC's claim against the interpled funds cannot be superior to the subcontractors and suppliers because it has not paid them. In *Pearlman v. Reliance Insurance Company*, 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962), the court noted that "the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the [contract retainage] fund . . ." *Pearlman*, 371 U.S. at 141, 83 S.Ct. at 237. 769 F. Supp. at 593.

C. The Assignee Banks – First National and DGNB

First National [the assignee bank] claims that its interest in the funds has priority over everyone else's claim because TAC assigned to First National its interest in the contract to cover the loans made to TAC on the construction project. DGNB's [the secured party bank] claim arises from the security instrument executed by TAC granting DGNB a security interest in all of TAC's contract rights.

In *Active Fire Sprinkler Corp. v. United States Postal Service*, 811 F.2d 747 (Second Circuit 1987) the court pointed out that: "it is elementary that an assignee generally takes the right subject to any claim superior to that right [citations] . . ."

As to the effect of an assignment, the Mississippi Supreme Court has stated that "[i]t is elementary that the assignee obtains no greater right in the thing assigned than was possessed by the assignor. . . ." [citation]

Consequently, the banks have only the right TAC had to the retainage fund which is not superior to the subcontractors' rights.

760 F. Supp at 594.

That court went on to note:

It is clear that the cases involving sureties claiming priority over assignees apply equally as well to the present case. In *Active Fire Sprinkler Corp.*, the court noted that:

Simply put, the equitable rights of sureties derive from the equitable rights of the clients protected by the bond – in this case the subcontractors. In *Henningsen*, the Supreme Court stated that the government has an equitable obligation to ensure the payment of laborers and suppliers on government construction projects. [citations]. *Pearlman* states that laborers have the right to be paid out of an unpaid contract balance when an insolvent general contractor fails to pay them. [citations] In both cases, the sureties, who had compensated the unpaid laborers and suppliers, had claims to the unpaid contract balances superior to the claims of bankruptcy estates and creditors. The sureties' claims arose because the sureties were subrogated to the rights of the suppliers and laborers. [citations] *Any rights held by the sureties were founded upon the rights of the unpaid laborers and suppliers* [citations].

The Fifth Circuit was presented with the same controversy in *Maryland Casualty Co. v. Delaney Lumber Co.*, 23 F. 2d 378 (Fifth Circuit 1928) .... The assignee bank claimed that "its equity [was] superior to that of the surety." [citation] In ruling that the surety's claim was superior to the assignee's claim, the court held that:

the bank did not become entitled, under either assignment, to any funds except such as were payable to the contractor. *Labor and material claims were superior to any claim held by the bank* ... The [assignee bank] could acquire no higher rights than the contractor had .... Therefore, the

> subcontractors and suppliers of materials which were used in this construction project have the highest priority of all the claimants.

760 F. Supp. at 595-596.

Another court has summarized this as follows:

> Read in unison, *Prairie State*, *Henningsen*, *Munsey Trust* and *Pearlman* yield the following priority ranking for entitlement to proceeds of government construction contracts:
>
> 1. the federal government exercising a right of offset;
>
> 2. unpaid subcontractors and sureties who have either paid subcontractors pursuant to a payment bond or completed the contract pursuant to a performance bond;
>
> 3. assignees of the general contractor including secured creditors; and
>
> 4. the general contractor or [his] bankruptcy trustee.

In re Pyramid Industries, Inc., 170 Bankruptcy Reporter 974, 980 (Bkcy. N.D. Illinois 1994).

Section 1103 of the UCC provides.

> Unless displaced by the particular provisions of this code, the principles of law and equity, *including* [emphasis added] . . . shall supplement its provisions.

The UCC does not expressly deal with this issue so it is not "displaced by [a] particular" provision of the UCC.

The court in *National Shawmut Bank of Boston v. New Amsterdam Casualty Co.*, 411 F.2d 843, 844-849 (1st Cir. 1969) analyzes that to determine:

> to what extent, if any, does the doctrine of [equitable] subrogation survive the passage of Article 9 of the UCC?

411 F.2d at 844.

That court in its analysis under Section 1103 noted the holding of the Massachusetts Supreme Judicial Court that:

> "No provision of the Code (UCC) purports to affect the fundamental equitable doctrine of subrogation." [citations] [and the First Circuit was not persuaded] that the Massachusetts court would take any different view here of the non-displacement of equitable subrogation by the Code.

411 F.2d at 847

After reviewing, among others, *Prairie State Bank*, *Henningsen*, *Pearlman* and *Munsey Trust*, that court concluded:

> It may well be . . . that to subject sureties to the filing requirements of the Code would improve and rationalize the system of financing public

> contracts. But equitable subrogation is too hardy a plant to be uprooted by a Code which speaks around but not to the issue.

411 F.2d at 849.

We also invite the Court's attention to *First Alabama Bank of Birmingham v. Hartford Accident and Indemnity Co., Inc.*, 430 F. Supp. 907 (N.D. Alabama S.D. 1977). The prime contractor there had assigned the proceeds of his contracts to his lender bank, which security interest was perfected in accordance with the Alabama UCC. When the prime contractor went into default, his surety paid the unpaid subcontractors and suppliers of the prime contractor. 430 F. Supp. at 908

The bank in that case argued that its compliance with the UCC entitled it to priority over the surety who had paid the subcontractors and suppliers. That court disagreed.

> This contention has been uniformly rejected by all courts which have considered the question. The Uniform Commercial Code protects only "contract rights," not those that arise by operation of law, and every court which has considered the matter has held that a surety's equitable subrogation rights, upon default of its principal - contractor, arise by operation of law, not contract, and that therefore a surety is not required to file financing statements under the Uniform Commercial Code to preserve its rights to equitable subrogation in the event of its principals default [citations].

430 F. Supp. at 910.

We return to *National Shawmut Bank* where that court noted:

> Prior to default, the contractor had the right to assign progress payments and had the Bank received payment it could not . . . had been divested by the surety. But upon default, the surety which is obligated to complete the work steps into the shoes of the government – not of the contractor which on default has forfeited its rights. It is subrogated not only to the right of the government to pay laborers and materialmen from funds retained out of the progress payments [citing *Prairie State Bank*, *Henningsen* and *Pearlman*] but also the government's right to apply to the cost of completion the earned but unpaid progress payments in its hands at the time of default. [citations including *Munsey Trust*].

411 F.2d at 848.

The California Court of Appeal refused to follow this 100 years of precedent that protects the rights of subcontractors, laborers and materialmen first to be paid out of the proceeds of the federal contract.

It ignored that the prime contractor/debtor cannot assign to or create a security interest in favor of its bank unless and until it pays the subcontractors, laborers and materialmen and thus acquires rights in the prime contract proceeds.

III. HERE THE BANK RECEIVED THE BENEFITS PRODUCED BY THE SUBCONTRACTORS, LABORERS AND MATERIALMEN. THAT IS SUFFICIENT TO OVERRIDE THE BANK'S SECURITY INTEREST, PARTICULARLY AFTER THE BANK FRUSTRATED THE GOVERNMENT'S EFFORTS TO CAUSE THE SUBCONTRACTORS, LABORERS AND MATERIALMEN TO BE PAID OUT OF THESE PROCEEDS.

The BANK has taken the funds out of the Subcontractor Account or Set Aside Account which were to pay the subcontractors, laborers and materialmen for that which they contributed to complete this project, which the government now has and is using.

We return to *National Surety Corp. v. United States*, 133 F. Supp. 381, 384 (Ct. Cl. 1955):

> It would be inequitable for the United States to retain the benefits of what the laborers and materialmen had done for it and pay to some one else money which the contractor should have paid to them. See *Henningsen* . . .

133 F. Supp. at 389.

David Miller, the Administrating Contracting Officer for the federal government who was administering the Prime Contract, tried to protect the priority of the subcontractors, laborers and materialmen first to be paid out of the proceeds of the Prime Contract. The BANK frustrated his efforts, refusing to cooperate in paying those funds to the unpaid subcontractors, laborers and materialmen under the Prime Contract to be paid ahead of the BANK.

It is egregious that the BANK would have prevented Mr. Miller and the government from discharging its duty to these subcontractors, labors and materialmen. That alone should estop the BANK from retaining these funds. Section 1103 specifically provides that estoppel is not superseded by the UCC.

It would appear that either (i) the acts of the BANK in attempting to frustrate David Miller's efforts to protect the rights of the subcontractors, laborers and materialmen in these funds or (ii) that these funds were taken from that Subcontractor's Account or Set Aside Account by the BANK clearly creates an estoppel.

There was no way in which BITE could have protected itself, which perhaps is the reason for the federal case law protections for persons such as BITE.

The misperception of the California Court of Appeal is capsulized by its comment on Page 12 of its opinion that:

> BITE made no showing . . . that during performance of the subcontract BITE had any expectations of payment from the Prime Contract funds in BANK's possession.

BITE had expectation of payment from the Prime Contract funds when they were paid, long before they got into the BANK's possession and before they were deposited in the Subcontractor account or Set Aside Account.

The error of law is demonstrated by the concluding sentence of the opinion of the California Court of Appeal on page 15 that:

> [*Dept. of Army*] *v. Blue Fox* does not stand for the proposition that subcontractors in government projects have the unequivocal right to be paid ahead of secured creditors [of the prime or general contractor].

It is the cases cited by this Court in *Blue Fox*, 525 U.S. at 264-265, which are *Prairie State Bank*, *Henningsen*, *Pearlman*, and *Munsey Trust*, that do stand for that proposition.

CONCLUSION

The proceeds of a government contract are first earmarked to pay the claims of the subcontractors, laborers and materialmen who contribute to the government project. Title to those proceeds never passes to the prime contractor. His assignee/secured party bank thus never gets any rights in those proceeds because he never had any rights in those proceeds.

This Court should grant certiorari to conform this decision of the California Court of Appeal to the decisions of this Court for over 100 years, and the case law based on them, to protect the rights of subcontractors, laborers and materialmen first to be paid out of the proceeds of the government contracts on which they work.

Respectfully submitted,

ROBERT L. RENTTO
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Attorney for Petitioner

APPENDIX A — OPINION OF THE COURT OF APPEAL FOR THE FOURTH APPELLATE DISTRICT, DIVISION ONE, STATE OF CALIFORNIA FILED SEPTEMBER 22, 2000

COURT OF APPEAL, FOURTH APPELLATE DISTRICT

DIVISION ONE

STATE OF CALIFORNIA

D033521

(Super. Ct. No. 718299)

BITE, INC.,

Plaintiff and Appellant,

v.

FIRST NATIONAL BANK,

Defendant and Respondent.

APPEAL from a judgment of the Superior Court of San Diego County, John S. Meyer, Judge. Affirmed.

The issue here is which of two creditors has a superior interest in the proceeds of the debtor's contract with the federal government: an unpaid subcontractor, under equitable principles, or a lender with a perfected security interest under

Division 9 of the California Uniform Commercial Code.[1] The trial court found in favor of the secured creditor and granted it summary judgment on the subcontractor's conversion and related claims. We affirm.

FACTUAL AND PROCEDURAL BACKGROUND

Systems Exploration, Inc. (SEI) was a "technology contractor involved in several contracts with the U.S. Government." In 1984 First National Bank (Bank) extended SEI a $1.5 million line of credit in exchange for a security interest in SEI's government contracts and their proceeds, among other things. Bank filed UCC-1 financing statements perfecting its security interest. Subsequently, the military awarded SEI a contract (Prime Contract) for "the construction of IMIS or the Integrated Management Information System, . . . a software support and maintenance system for weapons systems of the U.S. Air Force worldwide." It is undisputed that Bank's security interest in SEI's assets extended to the Prime Contract and its proceeds. In September 1988 SEI subcontracted with BITE, Inc. (BITE) for its provision of analytical services and materials on the IMIS project. The government did not require SEI to obtain any Miller Act payment bond.[2]

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1. Statutory references are to the California Uniform Commercial Code unless otherwise specified. In 1999, the Legislature revised and reorganized Division 9 of that code, but the changes are not effective until 2001. All references to the California Uniform Commercial Code are to the existing version.

2. Because sovereign immunity precludes subcontractors and suppliers from filing liens against public property, Congress enacted

(Cont'd)

Appendix A

SEI had financial difficulties during performance of the Prime Contract. In December 1991 Bank agreed to finance the purchase of SEI's assigned assets by a company named SYS. The assets remained subject to Bank's perfected security interest.

In March 1992 SEI and Bank entered into an agreement for "lock box" services. "[P]ursuant to this arrangement, all remittances to SEI and/or SYS under the assigned government contracts were made to a lock box [with Bank], deposited into a controlled account, and then applied against the credit line when the checks cleared."

SEI failed to pay BITE a balance of approximately $115,000 on the subcontract. BITE sought the assistance of the military's administrator of the Prime Contract, David P. Miller, in obtaining payment from contract funds in Bank's possession. Between 1993 and 1995 Miller unsuccessfully "sought concessions from [Bank], asking that [Bank] agree to allow the unpaid subcontractors under the Prime Contract to be paid ahead of [Bank]."

In January 1995 Bank approved of SYS's sale of its interest in SEI's assets to KRW Contracts and Financial Management, Inc. (KRW) in exchange for KRW's assumption of SYS's obligations to Bank. The contract stated Bank would "maintain a segregated SEI Subcontractor Account" for deposit of funds "identified by SYS as

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(Cont'd)
the Miller Act, requiring payment and performance bonds on specified federal construction projects. (*Department of Army v. Blue Fox, Inc.* (1999) 525 U.S. 255; 40 U.S.C. §§ 270a-270d.)

subcontractor funds. After full payment [of SYS's obligation to Bank], any amounts remaining in the SEI Subcontractor Account shall revert back to SYS for distribution[.]"

In February 1995 BITE discovered Bank had an account containing $255,000 in proceeds from SEI government contracts. BITE demanded payment from the account, but Bank refused to subordinate its security interest. In April 1995 Bank transferred its security interest in the SEI assets, including Prime Contract proceeds, to Big Canyon Investments, Inc. (Big Canyon). In February 1998 BITE sued Bank for conversion and related counts. BITE alleged it had a superior equitable lien on the Prime Contract proceeds and Bank wrongfully applied Prime Contract proceeds to its loan balances before the Big Canyon transfer. Bank successfully moved for summary judgment on the ground its perfected security interest was senior to BITE's unsecured claim. Judgment was entered on March 23, 1999.

DISCUSSION

I. *Standard of Review*

Summary judgment is proper only where there is no triable issue of material fact and the moving party is entitled to judgment as a matter of law. (Code Civ. Proc., § 437c, subd. (c).) "On review of a summary judgment in favor of the defendant, we review the record de novo to determine whether the defendant has conclusively negated a necessary element of the plaintiff's case or demonstrated that under no hypothesis is there a material issue of fact that requires the process of trial. [Citation.]" (*Ann M. v. Pacific Plaza Shopping Center* (1993) 6 Cal.4th 666, 673-674.)

Appendix A

II. *BITE's Theories of Recovery*

"It is the pleadings which delimit the scope of the issues on summary judgment." (*Couch v. San Juan United School Dist.* (1995) 33 Cal.App4th 1491, 1499.) BITE's complaint includes counts for conversion, constructive trust and resulting trust.

"Conversion is any act of dominion wrongfully exerted over another's personal property in denial of or inconsistent with his rights therein" (*Messerall v. Fulwider* (1988) 199 Cal.App.3d 1324, 1329.) "'A constructive trust is an equitable remedy to compel a person who has property to which he is not justly entitled to transfer it to the person entitled thereto. [Citations.]' [Citation.]" (*Farmers Ins. Exchange v. Zerin* (1997) 53 Cal.App.4th 445, 457.) "A resulting trust arises from a transfer of property under circumstances showing that the transferee was not intended to take the beneficial interest. [Citations.]" (11 Witkin, Summary of Cal. Law (9th ed. 1990) Trusts, § 297, pp. 1131-1132.) Bank, of course, cannot be liable under any of these theories if it enjoyed a superior security interest in the Prime Contract proceeds.

III. *Priority*

A

Personal property secured transactions are governed by Division 9 of the Commercial Code, California's version of the Uniform Commercial Code (UCC). (See generally Secured Transactions in California Commercial Law Practice (Cont.Ed.Bar 1986) §§ 1.1, 1.2, pp. 3-4 (Cont.Ed.Bar

hereinafter cited as CEB);[3] 3 Witkin, Summary of Cal. Law (9th ed. 1987) Secured Transactions in Personal Property, §§ 20-2 1, pp. 443-444.) Under the statutory scheme, a creditor may acquire a security interest in the debtor's personal property by obtaining written consent and giving value. (§§ 9203, 9110.) The creditor may "perfect" the security interest, and thereby protect it from the claims of third parties, by filing a UCC-1 financing statement or taking possession of the property. (See § 9303, subd. (1).) A Division 9 security interest, even if unperfected, prevails over the claim of a mere general creditor. (CEB § 4.2; §§ 9201, 9301, 9312, subds. (3)-(5).)

BITE concedes that Bank had a perfected security interest in the Prime Contract proceeds. BITE contends, however, that summary judgment was improper because as a materials and services supplier on the IMIS project it had a superior common law equitable lien on the funds.

The California Uniform Commercial Code contains a general instruction that, "[u]nless displaced by the particular provisions of this code, the principles of law and equity . . . shall supplement its provisions." (§ 1103.) "The purpose of . . . section [1103] is to allow the courts to fill gaps in the statute with recognized principles of law and equity. . . . In most cases, the courts are careful to use supplementary principles only as gap-fillers, not to 'displace' the rules of the UCC.'" (Clark, *The Law of*

3. "Divisions" of the California Uniform Commercial Code correspond to "Articles" of the UCC. (CEB, § 1.2.) UCC "section numbers are distinguished from those in the California version by the inclusion of a hyphen[.]" (*Ibid.*)

Appendix A

Secured Transactions Under the Uniform Commercial Code (1993) ¶ 3.14, pp. 3-156 to 3-157; see also 4 White & Summers, Uniform Commercial Code (4th ed. 1995) Priority Conflicts, § 33-20, p. 377; Hillman et al., *Common Law and Equity Under the Uniform Commercial Code* (1985) ¶ 1.06[3][a], pp. 1-18 to 1-19.)

Bank contends that any equitable lien of subcontractors on the proceeds of government contracts has been "displaced," within the meaning of section 1103, by sections 9104 and 9310. Subdivision (c) of section 9104 provides that Division 9 is inapplicable "[t]o a lien given by statute or other rule of law for services or materials except as provided in Section 9310 on priority of such liens[.]" Section 9310 provides that the *possessory* lien of a services or materials supplier ordinarily takes priority over a perfected security interest.[4]

Bank asserts that since section 9310 addresses only possessory liens, it impliedly precludes nonpossessory liens from taking seniority over perfected security interests. It is generally recognized, however, that section 9-103 of the UCC is not amenable to that interpretation. "Section 9-310 [of the UCC] is a limited priority rule which is only applicable to disputes between possessory lienholders and secured creditors. Other state law should resolve priority disputes in

4. Section 9310 states: "When a person in the ordinary course of his business furnishes services or materials with respect to goods subject to a security interest, a lien upon goods in the possession of such person given by statute or rule of law for such materials or services takes priority over a perfected security interest unless the lien is statutory and the statute expressly provides otherwise."

other contexts," including disputes between nonpossessory lien claimants and secured creditors. (4 White & Summers, *supra*, Scope of Article 9, § 30-12, pp. 93-94, fns. omitted.)

In *In re Brazier Forest Products, Inc.* (Wash. 1986) 724 P.2d 970, the court explained, "in accordance with the predominant authority, nonpossessory liens are outside the scope of [UCC] section 9-310 and therefore, their priority relative to a perfected security interest is governed by pre-Code statutory and common law." (*Id.* at p. 978.) The court held "this interpretation of [UCC] section 9-310 is more reasonable than inferring from the provision that all nonpossessory liens are subordinate to perfected security interests." (*Ibid.*, fn. omitted; see also *Oliver v. Bledsoe* (1992) 5 Cal.App4th 998, 1005.) Where equitable claims are not displaced by the UCC, they must be resolved in accordance with "judicial rulemaking based on applicable statutes, precedents, and principles and on the overarching policies and purposes of the code itself." (*Oliver v. Bledsoe, supra,* at p. 1005.)

B

According to one commentator, "[t]he most heavily litigated section in the entire UCC is § 1-103[.]" (Clark, *supra,* ¶ 3.14, p. 3-156.) In *Knox v. Phoenix Leasing, Inc.* (1994) 29 Cal.App.4th 1357, the court explained that section 1-103 of the UCC "has divided courts considering whether restitution can be had from a code-protected creditor. On the one hand, a decided majority of jurisdictions have disallowed the equitable remedy of restitution (whether termed unjust enrichment, quantum meruit, contract implied in law, etc.).

They are willing to accept occasionally harsh results as the price to be paid for preserving the integrity of the [UCC's] scheme for secured transactions, encouraging compliance with the code, and thereby ensuring a predictable system of creditor priorities. [Citations.] [5] On the other hand, California and . . . Colorado, while conceding considerable soundness to the majority position, have permitted restitution from a secured creditor." (*Id.* at pp. 1360-1361, fn. omitted, citing *Producers Cotton Oil Co. v. Amstar Corp.* (1988) 197 Cal.App.3d 638 (*Producers Cotton*); *Ninth Dist. Prod. Credit v. Ed Duggan* (*Colo.* 1991) 821 P.2d 788 (*Duggan*).)

In *Producers Cotton, supra,* 197 Cal.App.3d 638, Producers Cotton Oil Company (Producers) loaned Cecil Borboa more than $2 million in exchange for a security agreement covering his sugar beet crops and their proceeds. Borboa contracted to sell the 1981 crop to Amstar Corporation (Amstar), which was aware of Producer's security interest therein. Without obtaining a subordination agreement, Amstar deducted its harvest expenses and associated costs from the crop proceeds and remitted the

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5. For instance, in *Central Wash. Bank v. Mendelson-Zeller* (Wash. 1989) 779 P.2d 697, the Washington Supreme Court refused to create nonstatutory "equitable exceptions to the priority rules [because they] would hinder the purposes behind Article 9 — to simplify the law of secured transactions and create commercial certainty and reliance by creditors on Code provisions." (*Id.* at p. 705; see also *Peerless Packing Co. v. Malone & Hyde* (W.Va. 1988) 376 S.E.2d 161, 164-166, fn. 4 [only "virtually fraudulent conduct" would justify equitable claim for relief from UCC priorities in view of strong policy for adherence to the priority system].)

balance to Producers. Producers sued Amstar for conversion, alleging the deductions violated its security interest.

The court held that Amstar had a superior equitable interest in the crop proceeds under an unjust enrichment theory. "[W]hen a party possessing a security interest in a crop and its proceeds has knowledge of and acquiesces in expenditures made which are *necessary* to the development of the crop, and ultimately benefits from the expenditures, a party who, through mistake, pays such costs without first obtaining subordination, is entitled to recover." (*Producers Cotton, supra,* 197 Cal.App.3d at p. 660, original italics.)

In *Duggan, supra,* 821 P.2d 788, Ed Duggan, Inc. (Duggan) supplied feed grain to a livestock company whose accounts receivable were subject to a credit association's security interest. When the livestock company defaulted on its loan, cattle fed with Duggan's grain were sold and the credit association retained the proceeds. The Colorado Supreme Court determined Duggan could obtain restitution from the credit association notwithstanding its security interest. "In a situation where a secured creditor *initiates or encourages* transactions between the debtor and suppliers of goods or services, and benefits from the goods or services supplied to produce such debts, equitable principles require that the secured creditor compensate even an unsecured creditor to avoid being unjustly enriched." (*Id.* at p. 798, italics added.)

The *Duggan* court noted: "In *Producers Cotton* . . . the court held that the secured creditor's act of acquiescing in the harvesting of the secured collateral (crops) was a

sufficient basis for holding the secured creditor liable on the theory of unjust enrichment. However, in that case, the harvesting was necessary to the actual *preservation* of the secured collateral. . . . Here, the delivery of the corn was not essential to the secured collateral, but instead served to augment or enhance its value. In such a case, more than mere acquiescence is required to hold a secured creditor liable on the basis of unjust enrichment." (*Duggan, supra,* 821 P.2d at p. 797, fn. 17.)

In *Knox, supra,* 29 Cal.App4th 1357, Phoenix Leasing Incorporated (Phoenix) provided financing to Domaine Laurier Winery (Domaine) for the expansion of its plant. Phoenix obtained a security agreement covering Domaine's personal property, including after-acquired oak wine barrels Domaine ordered from Mel Knox. Phoenix paid Knox for the first shipment of barrels but declared Domaine in default on the loan before paying for the second shipment, and the barrels were included in the liquidation of Domaine's assets. Knox sued Phoenix for restitution under an unjust enrichment theory, and the court awarded him the resale value of the barrels.

The Court of Appeal reversed the judgment, explaining that although restitution claims against a secured creditor may be allowed in California under section 1103 in "a very limited class of cases" (*Knox, supra,* 29 Cal.App.4th at p. 1364), "simply pointing to benefit realized by the secured creditor will not suffice." (*Id.* at p. 1365.) The court held that a secured creditor's mere acquiescence is insufficient to upset Division 9 priorities, where the unsecured creditor's

provision of goods and services was useful but not essential to preserve the collateral. "The mere fact of augmenting or enhancing the collateral's value is by itself insufficiently notable to justify special equitable protection from article 9's priority structure. If allowed, this exception would swallow the rule." (*Id.* at pp. 1366-1367.)

Producers Cotton, Duggan and *Knox* do not concern the equitable lien claims of unsecured creditors, but such claims are also based on unjust enrichment. (4 Witkin, *supra,* § 173, p. 162.) "A promise to pay a debt out of a particular fund, without more, will not create an equitable lien on that fund." (*Farmers Ins. Exchange v. Zerin, supra,* 53 Cal.App.4th at p. 454.) "However, even a mere promise to pay from a specific fund may suffice to create an equitable lien if considerations of detrimental reliance or unjust enrichment are implicated." (*Id.* at p. 455.)

For instance, in *McBain v. Santa Clara Sav. & Loan Assn.* (1966) 241 Cal.App.2d 829, the court held "that, where suppliers of labor or materials have been induced to rely on the [construction] loan fund by either the *borrower or the lender,* their equitable liens on the fund should have priority over the claims of *both* of such last mentioned persons to the fund. Basically it is the fund itself and the arrangement for progress payments therefrom, created by the mutual agreement of the borrower and the lender, that constitutes the material inducement to the subcontractors and materialmen." (*Id.* at p. 841.) In *McBain,* the evidence established that the borrower specifically told the lien

claimants they would be paid for their services from the proceeds of the construction loan.[6] (*Id.* at p. 840.)

Based on the foregoing authorities, we conclude the court properly granted Bank's summary judgment motion. Bank met its burden of proving entitlement to judgment as a matter of law, based on its perfected security interest in the Prime Contract proceeds, and BITE raised no triable issue of material fact requiring trial. BITE made no showing that Bank initiated, encouraged or even acquiesced in transactions between BITE and SEI, or that during performance of the subcontract BITE had any expectation of payment from Prime Contract funds in Bank's possession. (See *Knox, supra,* 29 Cal.App.4th at p. 1367.)

Further, BITE made no showing that the materials and services it provided on the IMIS project were required to preserve the collateral, or that BITE's performance of the subcontract relieved Bank from the responsibility of having others perform the work. BITE simply produced no evidence suggesting Bank was unjustly enriched by retaining the Prime Contract proceeds.[7] Contrary to BITE's assertion, Bank's

6. In response to *McBain* and related cases, the Legislature enacted Civil Code section 3264, "eliminating altogether the supplier's equitable lien on construction loan accounts." *(Nibbi Brothers, Inc. v. Hoine Federal Sav. & Loan Assn.* (1988) 205 Cal.App.3d 1415, 1420; *Connolly Development, Inc. v. Superior Court* (1976) 17 Cal.3d 803, 827, fn. 25.)

7. BITE submitted the declaration of its president, John W. Cunningham, but he offered only conclusory statements regarding BITE's ostensible equitable lien against the Prime Contract (Cont'd)

mere refusal to subordinate its security interest does not evidence fraud, misrepresentation or bad faith.

C

BITE contends its superior equitable interest in the Prime Contract funds is established by federal cases concerning contests between banks and sureties on government construction projects requiring performance or payment bonds. (*Pearlman v. Reliance Ins. Co.* (1962) 371 U.S. 132; *Henningsen v. United States Fid. & Guar. Co.* (1908) 208 U.S. 404; *Prairie State Bank v. United States* (1896) 164 U.S. 227.) To any extent the cases are applicable in the nonsurety context, they are distinguishable on the basis of when the parties' security interests arose.

In *Prairie State,* the surety compelled to satisfy a performance bond and a lender both claimed equitable liens on the undisbursed balance on a federal construction contract. The United States Supreme Court held the surety was subrogated to the rights of the government to use the contract funds to complete the work in the absence of a performance bond, and "the rights of the parties depend upon whether" the surety's or lender's rights were first in time. (*Prairie State, supra,* 164 U.S. at p. 232.) The court concluded the surety's

(Cont'd)
proceeds. Neither the unsigned declaration of Miller — the military's administrator of the Prime Contract — nor the unsigned agreement between him and SEI requiring SEI to deposit proceeds into a control account with Bank for the benefit of SEI's creditors is competent evidence. In any event, any agreement exclusively between SEI and Miller would not establish BITE's detrimental reliance or Bank's unjust enrichment.

interest was superior because it arose upon execution of the bond, which was before the contractor's assignment of the contract proceeds to the lender. (*Id.* at pp. 232, 239.) The same scenario was present in *Henningsen* in the context of the surety's satisfaction of a payment bond. (*Henningsen, supra,* 208 U.S. at pp. 405-406.) In *Pearlman,* the Court held that a surety's equitable interest in the proceeds of a construction contract were superior to those of a bankruptcy trustee. The surety's interest arose when the prime contract was executed, before bankruptcy proceedings were commenced. (*Pearlman, supra,* 371 U.S. at pp. 133-134.)

As the court noted in *Maryland Casualty Co. v. Dulaney Lumber Co.* (1928) 23 F.2d 378, "[w]here performance of the contract results in a loss, it is the settled general rule in the federal courts that the right of a surety under its bond to the retained percentage is superior to the right of a bank, which advances money under an assignment from the contractor *taken subsequently,* or without notice to the surety." (*Id.* at p. 380, italics added, citing *Prairie State, supra,* 164 U.S. 227 and *Henningsen, supra,* 208 U.S. 404; see also *First Alabama Bank of Birmingham v. Hartford Accident & Indemnity Co., Inc.* (N.D. Ala. 1977) 430 F.Supp. 907, 910 [priorities between secured lender and surety subrogated to equitable interests of subcontractors dependent upon time respective rights arose].)

"A security interest is perfected when it has attached and when all of the applicable steps required for perfection have been taken. . . . If such steps are taken before the security interest attaches, it is perfected at the time when it attaches." (§ 9303, subd. (1).) Bank's security interest in the Prime

Contract was perfected when SEI entered into it and obtained rights thereunder, since Bank had previously filed a financing statement giving notice of SEI's after-acquired government contracts and related accounts receivable. (See *Biggins v. Southwest Bank* (9th Cir. 1974) 490 F.2d 1304, 1309-1310; *First Alabama Bank of Birmingham v. Hartford Accident & Indemnity Co., Inc., supra,* 430 F.Supp. at pp. 910-911.) The subcontract between BITE and SEI was entered into after Bank's security interest in the Prime Contract was perfected, and thus Bank's rights were superior as previous in time.

BITE's reliance on *Department of Army v. Blue Fox, Inc., supra,* 525 U.S. 255, is also unavailing. There, a subcontractor on an Army construction project without a Miller Act payment bond sought to impress an equitable lien on undisbursed contract funds held by the government. The court confirmed that "unless waived by Congress, sovereign immunity bars subcontractors and other creditors from enforcing liens on Government property or funds to recoup their losses." (*Id.* at p. 265.) *Blue Fox* does not stand for the proposition that subcontractors on government projects have the unequivocal right to be paid ahead of secured creditors.

Appendix A

DISPOSITION

The judgment is affirmed. Bank is awarded costs on appeal.

s/ Nares
NARES, J.

WE CONCUR:

s/ Kremer
KREMER, P.J.

s/ McDonald
McDONALD, J.

APPENDIX B — FINAL JUDGMENT OF THE SUPERIOR COURT FOR THE STATE OF CALIFORNIA FOR THE COUNTY OF SAN DIEGO DATED AND FILED MARCH 23, 1999

SUPERIOR COURT FOR THE STATE OF CALIFORNIA

FOR THE COUNTY OF SAN DIEGO

Case No. 718299

IC Judge: John S. Meyer
Dept: 61

BITE, INC., a Virginia corporation,

Plaintiff,

-vs-

FIRST NATIONAL BANK, a California corporation; and DOES 51 through 100, inclusive,

Defendants.

FINAL JUDGMENT BY COURT PURSUANT TO CODE CIV. PROC. § 437c

The above Court, having entered its Order Granting the Motion of Defendant FIRST NATIONAL BANK for Summary Judgment against Plaintiff BITE, INC. by way of a Ruling on Submitted Matter dated March 2, 1999, which adopted the Court's tentative ruling of February 19, 1999.

Appendix B

HEREBY ORDERS, ADJUDGES AND DECREES that Plaintiff BITE, INC. shall recover nothing from Defendant FIRST NATIONAL BANK. Defendant FIRST NATIONAL BANK is awarded its costs pursuant to a memorandum of costs to be filed. *Costs awarded in the sum of $662.35 (JRM 4/21/99)*

IT IS ORDERED.
Dated MAR 23 1999

s/ John S. Meyer
Judge of the Superior Court

APPROVED AS TO FORM:
Dated March 16, 1999

s/ Robert L. Rentto
Robert L. Rentto
Attorney for BITE, INC.

APPENDIX C — OPINION OF THE SUPREME COURT OF CALIFORNIA DENYING PETITION FOR REVIEW FILED DECEMBER 13, 2000

Court of Appeal, Fourth Appellate District,
Division One - No. D033521
S092649

IN THE SUPREME COURT OF CALIFORNIA

En Banc

BITE INC., Plaintiff and Appellant,

v.

FIRST NATIONAL BANK, Defendant and Respondent.

Petition for review DENIED.

s/ George
Chief Justice

Supreme Court, U.S.
FILED
APR 16 2001
OFFICE OF THE CLERK

No. 00-1435

In The

Supreme Court of the United States

BITE, INC., a Virginia corporation,

Petitioner,

v.

FIRST NATIONAL BANK, a California corporation,

Respondent.

On Petition For A Writ Of Certiorari To The California Court Of Appeals, Fourth Appellate District

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the California Court of Appeals correctly determined that, as between two creditors of a general contractor on a federal government contract, a lender with a perfected, first-in-time security interest in the proceeds of the government contract has a superior interest to that claimed by an unpaid subcontractor under equitable principles, and thereupon affirmed the trial court's grant of summary judgment in favor of Respondent First National Bank.

PARTIES TO THE PROCEEDING

Petitioner is BITE, INC., a Virginia corporation, and Respondent is FIRST NATIONAL BANK, a California corporation.

STATEMENT PURSUANT TO RULE 29.6

Respondent, FIRST NATIONAL BANK, a California corporation, does not have a parent corporation, nor does it have any publicly held companies that own 10% or more of its stock.

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STATEMENT OF JURISDICTION

Petitioner attempts to invoke the Court's jurisdiction under 28 U.S.C. § 1257(a). Respondent contends, *infra*, that 28 U.S.C. § 1257(a) does not provide a basis for jurisdiction.

CONSTITUTIONAL PROVISIONS, TREATIES, STATUTES, ORDINANCES, AND REGULATIONS INVOLVED

No provision of the United States Constitution or any treaty is involved in the decision below or the action as to which Petitioner seeks review. Only one federal statute is involved, 28 U.S.C. § 1257(a), and then only as a supposed basis for jurisdiction in this Court. The decision below was based primarily upon Sections 1103, 9104, 9203, 9301, 9303, 9310, and 9312 of the California Uniform Commercial Code and relevant California case law. Pursuant to Supreme Court Rule 24.1(f), those provisions are reproduced in the Appendix.

STATEMENT OF THE CASE

In 1984, Respondent First National Bank ("Bank") extended a $1.5 million line of credit to Systems Exploration, Inc. ("SEI"), a California technology contractor that was involved in several contracts with the United States Government. In exchange for the loan, SEI assigned to Bank and gave Bank security interests in its assets, including its government contracts and their proceeds.

Bank promptly filed UCC-1 financing statements perfecting its security interest.

Subsequently, the Government awarded SEI a contract (the "Prime Contract") for the construction of a software support and maintenance system for U.S. Air Force weapons systems. It is undisputed that Bank's security interest in SEI's assets extended to the Prime Contract and its proceeds.

In September 1988, SEI entered into a subcontract with BITE, INC. ("BITE") to provide services and materials in connection with the Prime Contract. The Government did not require SEI to post a payment bond (i.e., a Miller Act payment bond) to guarantee payment of SEI's subcontractors and suppliers, and SEI did not post a payment bond.

In 1992, a California corporation named SYS purchased SEI's assigned assets. The assets remained subject to Bank's perfected security interest. As part of the purchase transaction, SYS executed loan documents in favor of Bank, under which it agreed to repay SEI's existing loans from Bank.

In connection with the loan obligations, Bank agreed to perform "lock box" services for SEI and SYS. All remittances payable to SEI or SYS (or to Bank as assignee of SEI) under the assigned government contracts were made to the lock box, then deposited into a "control account" set up by Bank, and then applied against the outstanding loans when the checks cleared. Thereafter, Bank received payments from the Government under the Prime Contract and applied them to the outstanding loans.

In January 1995, Bank approved SYS's sale of its interest in SEI's assets to KRW Contracts and Financial Management, Inc. ("KRW") in exchange for KRW's assumption of SYS's obligations to Bank. The contract stated that Bank would maintain a segregated account for deposit of funds identified by SYS as subcontractor funds. After full payment of SYS's obligation to Bank, any amounts remaining in the account were to revert back to SYS for distribution.

SEI did not pay BITE approximately $115,000 on its subcontract. BITE demanded payment from Bank, but Bank refused to subordinate its security interest to BITE's claim. In April 1995, Bank transferred its security interest in SEI's assets, including the Prime Contract proceeds, to Big Canyon Investments, Inc. ("Big Canyon"). In November 1995, BITE sued SEI, SYS, and Bank, claiming nonpayment under its subcontract. In 1997, Bank was granted a summary adjudication of the only cause of action against it in that case. BITE subsequently settled the action with SEI, SYS, and Big Canyon for the sum of $40,000.

In February 1998, BITE filed the present action, claiming an equitable lien on the Prime Contract proceeds superior to Bank's security interest and alleging that Bank had unlawfully converted the proceeds by applying the same to the outstanding loans before the Big Canyon transfer. Bank moved for summary judgment on the ground that its first-in-time, perfected security interest was superior to BITE's later, unsecured, equitable claim. The trial court entered summary judgment in Bank's favor in March 1999.

BITE appealed to the California Court of Appeals, which reviewed the matter *de novo* and affirmed the trial court's decision. The Court of Appeals ruled, based entirely on relevant provisions of the California Uniform Commercial Code and predominantly California state case law, that:

> . . . Bank met its burden of proving entitlement to judgment as a matter of law, based on its perfected security interest in the Prime Contract proceeds, and BITE raised no triable issue of material fact requiring trial. BITE made no showing that Bank initiated, encouraged or even acquiesced in transactions between BITE and SEI, or that during performance of the subcontract BITE had any expectation of payment from the Prime Contract funds in Bank's possession.
>
> Further, BITE made no showing that the materials and services it provided on the IMIS project were required to preserve the collateral, or that BITE's performance of the subcontract relieved Bank from the responsibility of having others perform the work. BITE simply produced no evidence suggesting Bank was unjustly enriched by retaining the Prime Contract proceeds. Contrary to BITE's assertion, Bank's mere refusal to subordinate its security interest does not evidence fraud, misrepresentation or bad faith.

Pet'r's App. at 13a-14a (citation and footnote omitted). BITE's petition for rehearing by the Court of Appeals was

subsequently denied and, on December 13, 2000, the California Supreme Court denied BITE's petition for review.

ARGUMENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

I. There Is No Basis For Jurisdiction In This Court.

Petitioner has tried to make a "federal case" out of what is and should remain a state court dispute. The matter presented for review is, as the California Court of Appeals determined, fundamentally a question of state law under the California Uniform Commercial Code as supplemented by state common law. Pet'r's App. A at 8a. Petitioner nonetheless attempts to shoehorn its appeal within this Court's certiorari jurisdiction under 28 U.S.C. § 1257(a). State law matters that do not violate or impinge upon rights or privileges granted or preserved by the United States Constitution, federal statutes, or other federal authority fall outside the scope of the Court's certiorari jurisdiction as outlined in Section 1257. Accordingly, the petition for writ of certiorari must be denied.

Section 1257(a) of Title 28 of the United States Code provides a basis for certiorari jurisdiction in the Supreme Court for "[f]inal judgments or decrees rendered by the highest court of a State in which a decision could be had," where

> (i) the validity of a treaty or statute of the United States is drawn in question; or
>
> (ii) the validity of a statute of any State is drawn into question on the ground of its

being repugnant to the Constitution, treaties, or laws of the United States; or

(iii) any title, right, privilege, or immunity is specially set up or claimed under the Constitution or the treaties or statutes of, or any commission held or authority exercised under, the United States.

This case does not involve the validity of a United States treaty or statute. Nor has Petitioner challenged the validity of any State statute. BITE identifies only "equitable principles" as the source of its claimed priority to payment from the Prime Contract proceeds ahead of Bank and the supposed duty of the Government to pay subcontractors on government contracts before even first-in-time secured creditors like Bank. BITE's claims, without more, are insufficient to justify invoking this Court's certiorari jurisdiction under 28 U.S.C. § 1257(a). The petition for a writ of certiorari should be denied for want of jurisdiction.

II. There Is No Compelling Reason For Granting A Writ Of Certiorari.

BITE's petition should be denied because there is no compelling reason for granting certiorari in this matter. Rule 10 of the Supreme Court Rules specifies that certiorari review "is not a matter of right but of judicial discretion" and that review "will be granted only for compelling reasons." The character of the compelling reasons that the Court considers for granting certiorari review includes the following:

(a) a United States court of appeals decision either conflicts with the decision of another circuit court on an important matter, conflicts with a decision by a state court of last resort on *"an important federal question"*, or directly or indirectly departs from the accepted and usual course of judicial proceedings so as to call for an exercise of the Court's supervisory power;

(b) "a state court of last resort has decided *an important federal question* in a way that conflicts with the decision of another state court of last resort or of a United States court of appeals"; or

(c) "a state court or a United States court of appeals has decided *an important question of federal law* that has not been, but should be, settled by this Court, or has decided *an important federal question* in a way that conflicts with relevant decisions of this Court."

Sup. Ct. R. 10 (a)-(c) (emphasis added).

BITE has not identified any compelling reason for granting certiorari review of the decision below. Indeed, there is none. This case does not involve a conflict among the circuits or an appeal from the decision of a United States court of appeal. Nor does it involve a question of federal law, which is essential to justify certiorari review. In other words, BITE's appeal does not fall within the letter or the spirit of any of the "compelling reasons" described in Rule 10 for granting certiorari review, and BITE has not identified any other reason sufficient to warrant the issuance of a writ of certiorari.

III. A Supreme Court Decision Is Unnecessary As To The Question Presented Because Federal Law Is Well-Settled And Supports The Decision Below.

Even if a federal question were presented here, the Supreme Court and federal cases cited by BITE are distinguishable and, in any event, do not support its position. BITE's petition quotes extensively from the decisions but ignores their facts. In fact, well-settled federal law supports the decision of the Court of Appeals.

In dismissing BITE's arguments under the *Prairie State Bank* line of federal cases, the Court of Appeals distinguished each case based on (i) its context, because the cases involved claims brought by a surety, rather than by a subcontractor without the protection of a payment bond, and (ii) when the parties' respective security interests arose. Specifically, the court below correctly observed that in *Prairie State Bank v. United States*,[1] *Henningsen v. United States Fid. & Guar. Co.*,[2] and *Pearlman v. Reliance Ins. Co.*,[3] the surety's interest in the contract proceeds was superior to the competing interests because in each case the surety's interest arose earlier in time. Pet'r's App. at 14a-15a.

The Court of Appeals concluded that, even if the surety cases are applicable to this case, where no surety and no payment bond is involved, the correct and settled rule in the federal courts is that a surety's rights under its

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[1] 164 U.S. 227 (1896).

[2] 208 U.S. 404 (1908).

[3] 371 U.S. 132 (1962).

bond to government contract proceeds is superior to that of a lender under an assignment from the contractor only where the lender's assignment is "*taken subsequently* or without notice to the surety." Pet'r's App. at 15a (quoting *Maryland Cas. Co. v. Dulaney Lumber Co.*, 23 F.2d 378 (5th Cir. 1928) (citing *Prairie State, supra,* and *Henningsen, supra*)) (emphasis in original).

Here, it is undisputed that Bank's assignment and perfected security interest predated BITE's equitable interest by at least four years. Under the settled rule in *Maryland Casualty,* Bank's interest is superior to BITE's. The clarity and uniformity of the federal decisions on this issue make certiorari review of the instant case superfluous and unnecessary. The petition should be denied.

IV. BITE's Petition Misstates The Law At Issue.

Supreme Court Rule 15.2 requires a party opposing a petition for writ of certiorari to bring to the Court's attention any perceived misstatement of fact or law by the Petitioner "that bears on what issues properly would be before the Court if certiorari were granted." BITE's petition ignores the issue actually addressed and decided by the California Court of Appeals and disguises the true basis for the court's decision. In doing so, it misstates the law that was at issue below and would be at issue before this Court if certiorari were granted.

The issue that was addressed and decided by the California Court of Appeals was precisely this:

> [W]hich of two creditors has a superior interest in the proceeds of the debtor's contract with the

> federal government: an unpaid subcontractor, under equitable principles, or a lender with a perfected security interest under Division 9 of the California Uniform Commercial Code.

The Court of Appeals affirmed the trial court's summary judgment in favor of Bank, the secured creditor, entirely on the basis of California law.

Yet, BITE's petition does not even mention the State statute involved, the California UCC, or any of the California cases that supported the decision below. Instead, BITE refers only to the federal UCC and discusses only federal cases. The Court of Appeals distinguished, on two independent grounds, one entire line of cases relied on by BITE; BITE discusses those cases at length in its petition, but fails to address or even acknowledge the issues raised by the appellate court. BITE thus misrepresents this case as one posing a federal question and involving only federal authorities, and thereby attempts to mislead this Court into granting certiorari. Because no federal question is involved here, the petition should be denied.

CONCLUSION

The Seventh Circuit aptly characterized the plight of an unpaid subcontractor where no payment bond was provided as the party who "is left holding the bag." *Arvanis v. Noslo Engineering Consultants, Inc.*, 739 F.2d 1287, 1288 (7th Cir. 1984). The *Arvanis* court concluded that, although the result in that case was unjust, it was nevertheless the correct result where a federal contract

was permitted to proceed without payment bond protection for the subcontractors and suppliers. 739 F.2d at 1293.

It is regrettable that anybody must be left "holding the bag" in this case. That result is inevitable, however, in any case where the available proceeds from the prime contract are insufficient to satisfy the claims of all of the general contractor's creditors.[4]

That BITE will be left holding the bag in this instance does not elevate its priority among SEI's creditors nor convey to it any greater entitlement than Bank to payment from the Prime Contract proceeds. In fact, BITE's claim is inferior as a matter of law to Bank's claim. That is because – as the California Court of Appeals correctly determined – California state statutes and case law, as well as decisions of this Court and the other federal courts, unequivocally acknowledge the priority of a lender's first-in-time, perfected security interest and assignment over the subsequent, unsecured, equitable claim of an unpaid subcontractor.

It is undisputed that Bank in 1985 took due care to protect its interest in the Prime Contract proceeds by obtaining and duly perfecting a security interest in accordance with the California Uniform Commercial Code. In

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[4] It must be remembered that BITE has already accepted $40,000 from SYS and Big Canyon in partial settlement of its claim. The settlement reflects an election by BITE not to pursue SYS further and to pin all of its hopes for additional recovery on this action against Bank. In addition, it should be noted that Bank, even with the funds it did receive, still suffered a substantial loss on the loan it made.

contrast, when BITE later entered into the subcontract with SEI, it knew (or reasonably should have known) that no payment bond had been or would be posted. BITE took the job without the protection of a payment bond and thereby assumed the risk that it could be left "holding the bag" upon SEI's nonpayment or default.

Whether or not BITE's gamble was reasonable under the circumstances is irrelevant; fairness dictates that Bank should not be required to pay for the downside of BITE's business decisions. That is particularly true in view of the fact that Bank had no involvement whatsoever in the contract or relationship between BITE and SEI. BITE has produced no authority to the contrary.

For all of the foregoing reasons, Respondent First National Bank respectfully requests that the Court deny Petitioner BITE, Inc.'s petition for writ of certiorari.

Respectfully submitted,

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APPENDIX

28 U.S.C. § 1257(a)

Final judgments or decrees rendered by the highest court of a State in which a decision could be had, may be reviewed by the Supreme Court by writ of certiorari where the validity of a treaty or statute of the United States is drawn in question or where the validity of a statute of any State is drawn in question on the ground of its being repugnant to the Constitution, treaties, or laws of the United States, or where any title, right, privilege, or immunity is specially set up or claimed under the Constitution or the treaties or statutes of, or any commission held or authority exercised under, the United States.

Cal. Unif. Com. Code § 1103

Unless displaced by the particular provisions of this code, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

Cal. Unif. Com. Code § 9104(c)

This division does not apply to any of the following:

* * *

(c) A lien given by statute or other rule of law for services or materials except as provided in Section 9310 on priority of such liens.

* * *

Cal. Unif. Com. Code § 9203

(1) Subject to the provisions of Section 4210 on the security interest of a collecting bank, Sections 9115 and 9116 on security interests in investment property, and Section 9113 on a security interest arising under the divisions on sales and leases, a security interest is not enforceable against the debtor or third parties with respect to the collateral and does not attach unless all of the following are applicable:

(a) The collateral is in the possession of the secured party pursuant to agreement, the collateral is investment property and the secured party has control pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral and in addition, when the security interest covers crops growing or to be grown or timber to be cut, a description of the land concerned.

(b) Value has been given.

(c) The debtor has rights in the collateral.

(2) A security interest attaches when it becomes enforceable against the debtor with respect to the collateral. Attachment occurs as soon as all of the events specified in subdivision (1) have taken place unless explicit agreement postpones the time of attaching.

(3) Unless otherwise agreed, a security agreement gives the secured party the rights to proceeds provided by Section 9306.

(4) A transaction, although subject to this division, is also subject to the Retail Installment Sales Act, Chapter 1 (commencing with Section 1801) of Title 2 of Part 4 of Division 3 of the Civil Code; the Automobile Sales Finance Act, Chapter 2b (commencing with Section 2981) of Title 14 of Part 4 of Division 3 of the Civil Code; the Industrial Loan Law, Division 7 (commencing with Section 18000) of the Financial Code; the Pawnbroker Law, Division 8 (commencing with Section 21000) of the Financial Code; the Personal Property Brokers Law, Division 9 (commencing with Section 22000) of the Financial Code; the Consumer Finance Lenders Law, Division 10 (commencing with Section 24000) of the Financial Code; the Commercial Finance Lenders Law, Division 11 (commencing with Section 26000) of the Financial Code; and the Mobilehomes-Manufactured Housing Act of 1980, Part 2 (commencing with Section 18000) of Division 13 of the Health and Safety Code, and in the case of conflict between the provisions of this division and that statute, the provisions of that statute control. Failure to comply with any applicable statute has only the effect which is specified in that statute.

Cal. Unif. Com. Code § 9301

(1) Except as otherwise provided in subdivision (2), an unperfected security interest is subordinate to the rights of all of the following:

(a) Persons entitled to priority under Section 9312.

(b) A person who becomes a lien creditor before the security interest is perfected.

(c) In the case of goods, instruments, documents, and chattel paper, a person who is not a secured party and who is a transferee in bulk or other buyer not in ordinary course of business to the extent that he or she gives value and receives delivery of the collateral without knowledge of the security interest and before it is perfected.

(d) In the case of accounts, general intangibles, and investment property, a person who is not a secured party and who is a transferee to the extent that he or she gives value without knowledge of the security interest and before it is perfected.

(2) If the secured party files with respect to a purchase money security interest before or within 20 days after the debtor receives possession of the collateral, he or she takes priority over the rights of a transferee in bulk or of a lien creditor which arise between the time the security interest attaches and the time of filing.

(3) A "lien creditor" means a creditor who has acquired a lien on the property involved by attachment, levy or the like and includes an assignee for benefit of creditors from the time of assignment, and a trustee in

bankruptcy from the date of the filing of the petition or a receiver in equity from the time of appointment. "Lien creditor" does not include a creditor who by filing a notice with the Secretary of State has acquired only an attachment or judgment lien on personal property, or both.

(4) A person who becomes a lien creditor while a security interest is perfected takes subject to the security interest only to the extent that it secures advances made before he or she becomes a lien creditor or within 45 days thereafter or made without knowledge of the lien or pursuant to a commitment entered into without knowledge of the lien.

Cal. Unif. Com. Code § 9303

(1) A security interest is perfected when it has attached and when all of the applicable steps required for perfection have been taken. Such steps are specified in Sections 9302, 9304, 9305 and 9306. If such steps are taken before the security interest attaches, it is perfected at the time when it attaches.

(2) If a security interest is originally perfected in any way permitted under this division and is subsequently perfected in some other way under this division, without an intermediate period when it was unperfected,

the security interest shall be deemed to be perfected continuously for the purposes of this division.

Cal. Unif. Com. Code § 9310

When a person in the ordinary course of his business furnishes services or materials with respect to goods subject to a security interest, a lien upon goods in the possession of such person given by statute or rule of law for such materials or services takes priority over a perfected security interest unless the lien is statutory and the statute expressly provides otherwise.

Cal. Unif. Com. Code § 9312

(1) The rules of priority stated in other sections of this chapter and in the following sections shall govern where applicable: Section 4210 with respect to the security interest of collecting banks in items being collected, accompanying documents and proceeds; Section 9103 on security interests related to other jurisdictions; Section 9114 on consignments; Section 9115 on security interests in investment property.

(3)[1] A perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory and also has priority in identifiable

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[1] Enrolled bill contained no subdivision (2).

cash proceeds received on or before the delivery of the inventory to a buyer if all of the following occur:

(a) The purchase money security interest is perfected at the time the debtor receives possession of the inventory.

(b) The purchase money secured party gives notification in writing to the holder of the conflicting security interest if the holder had filed a financing statement covering the same types of inventory (i) before the date of the filing made by the purchase money secured party, or (ii) before the beginning of the 21-day period where the purchase money security interest is temporarily perfected without filing or possession (subdivision (5) of Section 9304).

(c) The holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory.

(d) The notification states that the person giving the notice has or expects to acquire a purchase money security interest in inventory of the debtor, describing such inventory by item or type.

(4) A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral or its proceeds if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within 20 days thereafter.

(5) In all cases not governed by other rules stated in this section (including cases of purchase money security interests which do not qualify for the special priorities set

forth in subdivisions (3) and (4)), priority between conflicting security interests in the same collateral shall be determined according to the following rules:

(a) Conflicting security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither filing nor perfection.

(b) So long as conflicting security interests are unperfected, the first to attach has priority.

(6) For the purposes of subdivision (5) a date of filing or perfection as to collateral is also a date of filing or perfection as to proceeds.

(7) If future advances are made while a security interest is perfected by filing, the taking of possession, or under Section 9115 or 9116 on investment property, the security interest has the same priority for the purposes of subdivision (5) with respect to the future advances as it does with respect to the first advance. If a commitment is made before or while the security interest is so perfected, the security interest has the same priority with respect to advances made pursuant thereto. In other cases a perfected security interest has priority from the date the advance is made.